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General Business Conditions

THE business news continues all of one kind. The industries are driving hard and expanding to meet the defense program, and increasing employment and payrolls keep trade at high figures. Although factory shipments are breaking records, unfilled orders in most lines have risen further. Some observers had expected business to moderate during the Winter, either because of seasonal influences or because buying might lag after forward commitments were built up. In fact, however, the holiday slackening was less than usual and the pickup afterward sharper than looked for. The rebound of automobile production to the Fall peak, which reflects unseasonally good sales as well as desire to build up dealers' stocks, impressively illustrates the strong trade and industrial position.

Although the security markets are affected by many anxieties, commodities are in strong demand, and in a significant number of cases prices are being held down only by the self-restraint of sellers. Despite all misgivings, buyers want to be covered ahead. They are hearing more talk of priorities, they see numerous examples now of prompt deliveries being rationed by sellers or commanding premium prices, and they are apprehensive of rising costs to come and of the effects on prices, even in cases where raw material supplies are abundant and productive facilities adequate. For these reasons forward buying is as much in favor as at any time since the upswing started, and doubtless would be still more widespread if sellers would accept more orders.

"Arsenal of Democracy"

The main cause of the business activity has been emphasized again, and with more force than before, by developments in Washington during the month. The federal budget estimates presented by the President contemplate an expenditure for defense in the first six months of 1941 averaging close to $800,000,000 a month. For the fiscal year 1942 the estimate rises to an average of $900,000,000 a month, without taking account of expected aid to the British. During the month of January disbursements have been about $550,000,000, which itself is higher than most people believed would be reached by this time. The projected expenditures are on a par with those of 1918. They could not be much greater if the country were at war. They emphasize, as does the drain on Great Britain's gold and dollar resources described subsequently in this Letter, the awful cost of war, the debts that are being piled up, and the gravity of the fiscal and monetary decisions which must be made.

The second development in Washington was the introduction of the so-called Lease-Lend bill, which is now the chief business of Congress. Its principal purpose is to assure against interruption of the flow of war materials to Great Britain; and either its passage in some form, or the loans which its opponents propose as an alternative, will constitute a complete affirmation of the policy of aid to Britain. The United States, as the President has said, is to be made the "arsenal of democracy".

This is the prospect which dominates the business situation. It is notice that the arms program, which for the most part is still in preparatory stages, will be pushed to the limit of capacity and as rapidly as plants can be equipped; and where differences of opinion exist as to the wisdom of plant expansion the balance undoubtedly will be tipped by the desire to provide a margin of safety over estimated needs.

Plant Expansion Programs

In his budget speech the President said 125 armament plants were under contract and more planned. Building activity is outstanding in the business reports. Heavy engineering construction awards in four weeks of January totaled $502 millions, according to the Engineering News-Record compilation, an increase of 149 per cent over last year. The Dodge building reports, which include all types of contracts and do not cover the Pacific Coast, for December were the highest in any month ex-

cept one since the middle of 1929; and one-third of the awards were for direct defense construction. Factory buildings represented $80 millions of the total, duplicating the November figure. This is double the rate in the best months of 1937, the only other period since the depression began in which factory construction has been substantial. Defense housing requirements are another large element in the building increase. Publicly owned housing awards in December amounted to $70 millions, by far the highest ever recorded.

By all signs contracts for plant expansion and new housing will be heavy for some time. Various authorities estimate the probable gain in total building in 1941 at 10 to 15 per cent. The defense officials and the brass manufacturers are discussing plans to increase brass-making capacity. Contracts for new ship building facilities are to be let. The contention of some groups in Washington that large additions should be made to steel capacity, to which the steel manufacturers reply with well-supported calculations that they can produce all the steel that can be used, has started a major controversy. Meanwhile it may be noted that steel ingot capacity was increased during 1940 by 2,500,000 tons, the largest gain in ten years. Further increases of possibly 2,000,000 tons are already scheduled for this year, and total capital expenditures by the steel industry in 1941 are budgeted at $282,000,000, which is 65 per cent greater than the 1940 expenditures. Electric power producers are expected to spend $100,000,000 more than last year, and railroad equipment buying also to show a gain.

Work on many of these contracts will continue through 1941. In due course the armament plants will be completed, but after construction comes production. Experienced observers agree that when plants get into operation they will give more employment, require more materials, and start more buying power spreading around the circle than the construction work is generating. Thus the shift of activities, to be expected later in 1941, portends in the aggregate a further expansion rather than a decline. It is possible that some of the lighter industries, which have already been in production for several months on army and cantonment equipment, will have fewer orders of this type for the 1942 fiscal year, and may show some recession. Evidently, however, any slackening from this cause should also be offset by armament production.

The Price Situation

Since forecasts of this kind are almost universally accepted, the major interest of business men is not in industrial trends but in prices. It is axiomatic that the higher the forecasts of defense activity, the greater the probable interference with normal peace-time operations, the more danger of priorities and rising costs, and the greater upward pressure on prices. More brass capacity, for example, will increase in due time the demand for copper, zinc, fuel, power and labor.

Fortunately there are two basic influences protecting against inflationary price rises. One is the sufficiency of supplies of industrial materials, with some exceptions, and the abundance of foods. The other is the attitude of business and Government. The great majority of business men, remembering 1918 to 1921, also 1937 and the 1938 aftermath, realize that they bear a heavy responsibility for maintaining order in the markets. Buyers cannot be criticized for wanting forward coverage, but if they pile up speculative stocks of goods and materials they will contribute to the price inflation which they dread. Sellers, on the other hand, have the chief responsibility for keeping goods moving without withholding supplies, and without taking advantage of the situation to force price increases which might justify demands for higher wages, and set the wheels turning in a vicious inflationary circle.

If both parties maintain their present attitudes supplies will go around; and in the few cases where scarcity is real it is more in the general interest to economize in ordinary consumption than to force an uprush of prices. Mr. Knudsen has stated within the month that in its 1942 models the automobile industry will use substitutes for zinc in places where the metal fills solely a decorative purpose, as in radiator grills. The bulk of the zinc used in automobiles, which was 76,000 tons in 1939, falls in this category. Thus a substantial quantity will be released for brass making and other needs.

Markets on an Even Keel

For the most part the principal commodity markets continue on an even keel. The producers of primary zinc and copper are still rationing their sales but not raising prices, although secondary metal commands premiums, and although in the case of zinc Mr. Dallas, President of Revere Copper & Brass, says that 1,000,000 tons could be consumed in 1941 if it were available, against estimates of production (for both domestic use and export) of around 850,000 tons. The policy of filling copper requirements by imports of foreign metal, rather than boosting prices to stimulate the last ounce of domestic production, has been reaffirmed; the original purchase of 100,000 tons of Mexican and South American copper by the Metals Reserve Company will be followed by other purchases.

The steel manufacturers have said frequently that they will not raise prices unless compelled to by rising costs. A threat of a runaway market in steel scrap was checked during the month

by Mr. Henderson of the Defense Advisory Commission, acting with the support of the leaders of the scrap industry. The Commission is said to have been assured last Fall that an adequate supply of scrap could be provided at the equivalent of $20 or thereabouts for the No. 1 heavy melting grade at Pittsburgh, but the price rose early in January to $23.75, which trade reports say was due to withholding supplies by some dealers and scrap producers. Mr. Henderson's proposal for bringing out more offerings was to place by voluntary action a ceiling over the market, thereby removing the incentive to hoarding, and the price has been brought down to $21.50.

The lumber market is another which is coming down from its rise last Fall, due both to the efforts of Mr. Henderson and to the underlying fact that there is enough capacity to produce all the lumber this country can use, and considerably more. Consumption of lumber in cantonment construction is approaching its peak; orders for this purpose will be smaller in 1942, and will not be bunched as they were last Fall.

To be sure, higher prices are desirable in cases where more production is needed, and where it can be had only by stimulating operations of higher cost producers. Fortunately there are few such cases. Supplies of foreign wool, hides, lead, and other staples formerly sold in Europe are being brought here, partly through government purchases, to supplement domestic supplies. With this help most requirements can be taken care of amply, provided hoarding does not take place.

Manufactured Goods Prices and Wage Rates

Prompt deliveries of some manufactured goods are scarce, due to congestion in demand; but buyers should be sure that the tightness is due to consumption, and not chiefly to anticipation of needs. Cotton goods have advanced under a strong demand, and unfilled orders are huge. After full allowance for army and navy purchases, however, more goods are being made for other uses than the country has ever needed in the past. Mill consumption of raw cotton has been running at a rate approaching 9,500,000 bales for the season, against a previous record of 7,950,000 in 1936-37.

In manufactured goods the question is not only one of raw material costs but of wage rates. Demands for higher wages are increasingly in prospect. This is where the principal inflationary danger exists. There is no rising cost of living, at least of a general character, to support arguments for higher wage rates; and labor is making great gains through more people at work, longer hours, over-time rates, and consequent increases in weekly and monthly wages. If, in an effort to extend these gains, wage demands proceed to the point of forcing price increases, the vicious circle will start at that point.

Wherever the start, a spiral of cost and price advances would almost inevitably be kept moving by speculation, inventory accumulation, rising living costs, and the other cumulative influences. The self-interest of buyers and sellers, employers and labor, and taxpayers and government should induce co-operation and self-restraint; and consideration of the fiscal problems discussed on later pages of this Letter is a duty not of the Government alone, but of everyone.

The Labor Supply

Information now available, while of a tentative and preliminary nature, suggests that the extent of unemployment may be placed too high by many of the current estimates. A partial sample of figures collected during the population census last April indicates that 5,110,000 were totally unemployed then, and an additional 2,380,000 were on W.P.A., etc., a total of 7,490,000. This compares with the estimate of the same date by the National Industrial Conference Board, whose figures have been among the lowest, of 9,017,000, a difference of 1,527,000. However, the census figures included 1,789,000 persons whose status was indeterminate. Thus the question is left unsettled to some extent until final census returns are available.

If the unemployed were in fact over-estimated last April by 1,527,000, the over-estimation has been carried forward to the present time. Meanwhile, unemployment has declined, the drop from April through December having been 2,056,000 according to the Board. If this decline is applied to the census figure for April it indicates an unemployment in December of 5,434,000, including both W.P.A. workers and the large number of those who are probably unemployable and in effect have passed out of the labor force.

Doubtless the effective labor reserve is still large, although not as large as many believe, and more workers can be spared from the farms. The problem is to train the unemployed and put them effectively at work. It is a technical problem, to be dealt with co-operatively by the industries and the educational system. If workers can be trained as rapidly as they are needed, the existence of this labor reserve will prove to be the most effective force for countering inflationary influences that the country possesses. At the same time, its existence should not lead to a feeling of complacence or false security. The fact is that, even while unemployment is still substantial, a boom is under way and industrial activity in many lines is straining at capacity. Private and public policies have to take both conditions into account. From either view, it is plain that the emphasis belongs on increased production and

orderly markets rather than on higher prices, and on more work and stable living costs rather than higher wage rates.

The kind of proposals that may be induced by centering attention exclusively on the unemployment are illustrated in an Associated Press dispatch from New Orleans, January 28, which quotes Howard O. Hunter, Acting Commissioner of the Work Projects Administration, as outlining a program for providing work for "the 8,000,000 jobless in this country." Mr. Hunter said these are some of the things that could be done:

> Civil and military airports. Transcontinental highways that go from somewhere to somewhere and are big enough to land a plane on. We could use thousands of public health laboratories overnight. Drainage projects, such as to control malaria in the South. Hundreds of thousands of swimming pools.

Surely no elaboration of the question is necessary to show what effects the demands for labor and materials for "thousands of public health laboratories" and "hundreds of thousands of swimming pools" would have in the present situation, — how greatly they would interfere with and delay the defense program and contribute to inflationary trends, to say nothing of the cost and the problem of financing the debt.

1940 Business Profits

Annual reports of corporate earnings for 1940, issued thus far, show that substantial sales increases produced sharp gains in net profits of most companies as compared with 1939. Most of the gain was made in the first nine months of the year. The fourth quarter showed comparatively little increase because of the heavy charges required for federal income and excess profits taxes, and also because profits in the final quarter of 1939 were relatively high. Numerous representative companies had actual decreases in the fourth quarter as compared with the preceding year, despite a larger volume of sales.

A preliminary tabulation of the annual reports of 390 leading industrial corporations, including many whose fiscal years closed prior to December 31, shows combined net profits, less deficits, of approximately $856,000,000 after taxes in 1940. This represents an increase of 32 per cent over the $648,000,000 net total reported by the same companies in 1939. Upon the net worth or shareholders' equity of the group, aggregating $8,419,000,000 on January 1, 1940, last year's profits represented a return of 10.2 per cent, compared with a rate of 7.8 upon a slightly smaller net worth in 1939.

These figures, it should be noted, do not include companies engaged in distribution, financial corporations, railroads, utilities and certain others which will be included in our more comprehensive tabulations as they become available. Past experience indicates that their inclusion will reduce the percentage increase in profits and also the average rate of return. The fact that earnings of 1939-1940 were considerably better in general than the average results during the past decade will assist business in recouping losses and in financing the plant expansion and heavy production now called for.

The President's Budget Message

The budget which the President submitted to Congress last month is a reflection of the country's aroused sense of peril in a world at war. When he presented his budget to Congress a year ago, the President expected that total expenditures for the fiscal year 1941 would amount to about $8½ billions. Expenditures for national defense were set down at approximately $1.8 billions — which now seems a small sum but was then the largest for any year since 1920. The deficit (excluding sinking fund) was placed at something over $2 billions.

But much has happened in the past year. With the spread of the conflict in Europe and growing alarm for our own security, the nation has embarked upon a vast armament program the ultimate cost of which is unknown but on the basis of appropriations, contract authorizations and present budgetary recommendations already reaches $28 billions. All this has profoundly altered the budget prospects for this year and for years to come. In his message last month the President gave recognition to these changed conditions, and we are now confronted with revised estimates for the fiscal year 1941 lifting defense expenditures to $6½ billions, total expenditures to $13 billions, and the deficit to $6.2 billions.

At the same time the President presented the first official estimates of receipts and expenditures for the fiscal year 1942. In that year —when the armament program should be running full blast — the President expects total expenditures of approximately $17½ billions, exclusive of aid to Great Britain. Expenditures for national defense alone are put at $10.8 billions, and the deficit at $9.2 billions.

In other words — as a glance at the table on the next page will show — projected armament spending is already raising our budget totals to around World War peaks. Though we remain at peace, our military and naval costs for this year will exceed the totals for the war year 1918, and by 1942, according to the estimates, will be well up to the high levels of 1919. Fortunately, the estimated tax revenues both for 1941 and 1942 are well above those of the World War period, which is tending to hold the expected deficits lower than at that time.

In viewing the 1942 budget, it will be recognized that the estimates are more than usually tentative, and no doubt will be substantially revised. Revenues, for example, are calculated

United States Government Receipts and Expenditures, 1914-1942
(In Millions of Dollars)

Year Ended June 30	Total Net Receipts	Net Expenditures: National Defense*	Net Expenditures: All Other	Net Expenditures: Net Total	Net Surplus or Deficit
1914......	$ 735	$ 263	$ 472	$ 735	—
1915......	698	268	493	761	— 63
1916......	783	286	448	734	+ 48
1917......	1,124	567	1,411	1,978	— 853
1918......	3,665	6,100	6,597	12,697	— 9,033
1919......	5,152	10,965	7,550	18,515	—13,363
1920......	6,695	2,297	4,106	6,403	+ 292
1921......	5,625	1,693	3,423	5,116	+ 509
1922......	4,109	888	2,485	3,373	+ 736
1923......	4,007	675	2,620	3,295	+ 712
1924......	4,012	603	2,446	3,049	+ 963
1925......	3,780	626	2,437	3,063	+ 717
1926......	3,963	599	2,499	3,098	+ 865
1927......	4,129	614	2,360	2,974	+ 1,155
1928......	4,042	643	2,460	3,103	+ 939
1929......	4,033	698	2,601	3,299	+ 734
1930......	4,178	721	2,719	3,440	+ 738
1931......	3,190	667	3,004	3,671	— 481
1932......	2,006	664	3,871	4,535	— 2,529
1933......	2,080	651	3,213	3,864	— 1,784
1934......	3,116	540	5,471	6,011	— 2,895
1935......	3,800	710	6,300	7,010	— 3,210
1936......	4,116	912	7,754	8,666	— 4,550
1937......	5,029	935	7,242	8,177	— 3,149
1938......	5,855	1,028	6,211	7,239	— 1,384
1939......	5,165	1,163	7,544	8,707	— 3,542
1940......	5,387	1,580	7,418	8,998	— 3,611
1941†....	7,013	6,464	6,738	13,202	— 6,189
1942‡....	8,275	10,811	6,674	17,486	— 9,210

Source: Compiled from President's Budget Messages and annual reports of the Secretary of the Treasury. Excludes expenditures for net appropriations to old-age insurance trust funds and corresponding social security tax receipts; also excludes expenditures for debt retirement through sinking fund. * Excludes expenditures charged to War Department for rivers and harbors, and flood control; also for Panama Canal. † Revised budget estimate. ‡ Original budget estimate.

United States Government Direct Debt, 1914-1942
(In Millions of Dollars)

June 30	Total	June 30	Total	June 30	Total
1914........	$ 1,188	1924........	$21,251	1934........	$27,053
1915........	1,191	1925........	20,516	1935........	28,701
1916........	1,225	1926........	19,643	1936........	33,778
1917........	2,976	1927........	18,510	1937........	36,425
1918........	12,244	1928........	17,604	1938........	37,165
1919........	25,482	1929........	16,931	1939........	40,440
1920........	24,298	1930........	16,185	1940........	42,968
1921........	23,976	1931........	16,801	1941*......	49,157
1922........	22,964	1932........	19,487	1942†......	58,367
1923........	22,350	1933........	22,539	1943	

Source: Compiled from President's Budget Messages and annual report of the Secretary of the Treasury. Excludes guaranteed debt of government agencies. * Revised budget estimate. † Original budget estimate.

without allowance for increased taxes which the President recommends and which are practically certain to come. Expenditures take no account of aid to Great Britain which, if present plans materialize, may run to billions of dollars. Moreover, the rate of spending will be conditioned also by the productive capacity of the industries, and the extent to which the United States is affected by the war.

However, taking the figures as given, the estimates call for issuance of some $13 billions of new direct debt obligations before June 30, 1942. At that time the direct debt is expected to reach about $58 billions, plus whatever additional borrowing may be needed to finance British aid.

Since under the present law the federal debt limit is set at $49 billions, legislation authorizing an increase to $65 billions has been introduced and is now pending in Congress. Although the President in his budget message questioned the significance of a statutory debt limit "except as it serves as a fiscal monitor," Congress apparently was not impressed with the idea of doing away with this safeguard. The fact is that "serving as a fiscal monitor" is precisely what the debt limit is for and why it is valuable. While not a guarantee against excessive borrowing, it nevertheless acts as a signal mark which all may see and be warned by and where opponents of increased spending may rally their forces for criticism and debate.

Ways of Financing the Defense Program

How does the President propose to meet the terrific cost of this huge program? Briefly, in three ways: (1) reduction in non-defense expenditures, (2) increased taxation, and (3) borrowing.

Manifestly, the attack upon the problem must come from all three angles, and one of the first things to be done, it would seem, would be the strictest paring down of non-defense spending wherever possible all along the line. This would serve the triple purpose of reducing the size of the deficit to be financed, diminishing the competition of government with private spending, and lessening the danger of inflation.

In the budget presented last month the President placed non-defense expenditures for 1942 at $6,674,000,000, against $6,738,000,000 for 1941 and $7,418,000,000 for 1940 (see accompanying table). The change is in the right direction but falls far short of what might have been expected last December when he announced that all non-defense expenditures would be cut "to the bone." The principal reductions are in work relief and the general public works program; even so, the work relief item remains over a billion dollars, notwithstanding the stimulus to business activity and private employment being given by the defense program.

Apart from the foregoing two items, the budget affords little evidence of any serious effort at real economy. Federal subsidies to agriculture in 1942, while budgeted substantially below the all-time high reached in 1940, are still expected to cost the Treasury over a billion dollars — about 4 per cent less than in 1941. "Aids to youth" (Civilian Conservation Corps and National Youth Administration) will exceed $360,000,000 in 1942, against $369,000,000 in 1941 and $378,000,000 in 1940. This is in spite of hundreds of millions to be spent in federal aid under other headings and despite also the pick-up in private employment.

Moreover, some of the apparent reduction in non-defense costs shown by the budget is the

result of changes in classification and accounting. Senator Byrd of Virginia has stated that the total cost for so-called normal operations of government in 1942 will exceed $8 billions, as against the $6.7 indicated in the budget.

The National Economy League, in a careful study of expenditures made before the new budget was announced, placed the possible non-defense savings in 1942 at $2 billions, allowing for moderate programs of relief and agricultural aid. On this basis the non-defense budget would be reduced to about $5 billions, which would still be double the average level of the 1920s.

While of course it is difficult to get agreement on specific economies, it is hard to understand why, with the industries active, the non-defense budget should stand but little more than a billion dollars below the peak reached in the soldiers' bonus year 1936. It is hard to see why the totals should remain higher than in the depression years when the need for relief was acute and the Government was trying in every way to spend money to provide jobs and to promote recovery.

In the face of the huge emergency program, it is disturbing to find new proposals for other types of spending still being pressed upon the Treasury. The farm organizations still demand more aid for agriculture, despite the enormous subsidies now being paid. There is a widespread tendency to indiscriminate lumping of all pet projects as national defense in order to secure their adoption. Witness the resurrection of the costly St. Lawrence Ship Canal and Power Project—an undertaking of questionable merit to start with, and one which would take five to ten years to complete; and there are other examples.

State and Municipal Costs

Nor should we fail at this point to stress the importance of keeping down state and local government expenses and debt at a time when federal expenses and debt are rising so rapidly. How many realize that the states and their subdivisions account for nearly half of our total taxes and a third of the aggregate public debt?

As with all non-defense spending, there is need for the utmost economy in these local finances. Many communities are now experiencing a decline in the relief load and an increase of revenues as a result of the national defense program. Such funds, instead of being turned to new expenditures, should be used to reduce taxes or debt.

Governor Lehman of New York State took a step in the right direction in his budget presented to the New York State Legislature last month, when he proposed for the fiscal year 1942 a reduction of approximately $9,000,000 in total expenditures, and the repeal next year of the 1 per cent emergency tax on personal incomes which has been imposed (in addition to the graduated normal income tax) since 1933. While the recommendation for tax reduction was made possible more by a rise in revenues than by a reduction in expenditures, nevertheless the policy of retrenchment in evidence is welcome. Like the attempt to cut federal non-defense spending, it needs to be carried further.

In determining state and municipal budgets, it would be well to be thinking also about the time when the great defense program will be completed. At that time there may be a real need for public works and housing to maintain production and employment. Both in Great Britain and in Canada, public works have been greatly curtailed not only to release labor and production for war needs now, but also to save them against a possible post-war depression. Here in this country the Government is talking about the necessity for priorities while at the same time both federal and local authorities are themselves putting up propositions definitely competitive with defense.

The Question of Taxation

The second method by which the President proposes to meet defense costs is by taxes. In the last war most of the belligerents made the mistake of postponing adequate tax measures too long. As a result inflation was given a head start.

We must not repeat this error. Sound policy demands that we meet as much as possible of the defense costs as we go along. Our problem, however, is to determine how much and in which manner we can tax without impeding the defense program. We must remember that there are two sides to every tax. One is the income which it yields the Government, and the other is the economic effect — and every tax has an economic effect. If the stream of spending is cut down too drastically, it may unnecessarily penalize many of the non-defense industries and throw people out of work so that instead of getting more revenues the Treasury winds up with greater relief bills to pay.

If we cut into the savings area too deeply, business and individuals will be unable to take risks because they will have no fat to absorb losses; and that will mean not only choking off private initiative in industrial lines generally but — what is more serious at the moment — it will mean holding back the expansion of the defense industries which are called on to take very substantial risks in the rearmament program. And we all know what will happen if private industry is hampered in doing the job. We will be told that private capital has failed, and that the Government must take over.

In his statement to Congress, the President recommended additional taxes this year, but did not attempt to specify what form they

should take beyond indicating that they be based upon ability to pay and the prevention of abnormal profits. He expressed opposition to making taxation too restrictive while the country still has idle labor and manufacturing capacity, and suggested for the present at least a tax policy aimed at collecting progressive taxes out of a higher level of national income.

The theory of an ideal defense tax is clear. All will agree that it should bring needed revenue to the Treasury, tap idle money in the bank, eliminate unwarranted profits, and yet not discourage the economic system to the point where the law of diminishing returns begins to operate. The practical, and more difficult, problem is to agree on the tax. It must be borne in mind, in considering proposals for higher taxes, that already within the past year we have had two major increases in federal tax rates, and raised them to extremely high levels — higher even than at the peak during the last war.

Certainly in weighing proposals for more taxes we will want to take account of the possible yield from present taxes at rising levels of national income. The Secretary of the Treasury, in his annual report last month, gave tentative estimates of tax receipts at assumed higher levels of national income. These indicate that a $90 billion national income might yield, after a suitable time lag, around $11.2 billions in taxes and a $100 billion national income might yield around $13.4 billions.

Taking the $90 billion estimate of the Secretary as one that might readily be reached, it will be seen that even with a $17 billion budget the deficit would be reduced to below $7 billions; and a determined effort to cut non-defense spending might lop off a billion or more in addition.

These figures are not given as a forecast, or to imply that we can go along without additional taxes. Unquestionably, we must get ready for more taxes, and in the long run we shall all be better off if by taxing ourselves now we can avoid inflation later. However, before we go forging ahead on a new tax program we ought, first, to know more about the probable yield from present taxes, and, second, we ought to consider what kinds of taxes are called for by the new situation. At some point as the defense program develops, we shall probably find — as other countries have found — that we shall need to cut down the stream of income spending in order to retard the increase in private consumption and so release more goods and materials for the defense program.

At that point it may well be that we should turn more to selective excise taxes which can be made effective quickly, not only for increasing revenues, but also for restricting consumption of non-defense goods, and thus dealing with inflationary tendencies. There is much to be said for an increase in income taxes which will reach down in the lower brackets where, with increasing employment and payrolls, the rise in mass income is likely to be the largest. Certainly it is clear that with any general increase in priorities against consumption goods, some kind of a tax that will affect consumption demand is essential to avoid open invitation to competitive bidding for limited supplies and consequent driving up of prices.

While the wise thing for the moment is to postpone any decisions until after the March 15 taxes are in, people should be thinking about this problem and making up their minds where added taxes should go. And, it might be added, everybody will be more willing to pay additional taxes if there is economy in non-defense costs, of which there is, unfortunately, no real sign as yet.

The Question of Borrowing

The third method by which the President proposes to meet defense costs is by borrowing. Both the budget itself, and the request for the increase in the debt limit, are evidence that the President feels that much of the cost will have to be met in this way.

Such being the case, it becomes particularly important as the defense program develops that an increasing proportion of the government securities sold should be lodged with individuals and institutions other than the commercial banks. The reason for this is that when the banks subscribe to government loans they create additional deposits, which increases the total volume of purchasing power available. It is from this multiplication of purchasing power, usually associated with deficit financing, that the danger of inflation chiefly arises. If government bonds could be sold to individual and institutional investors and subscribed for out of savings, this danger would be greatly reduced. For what would take place then would not be an increase in the volume of purchasing power, but merely a transfer from one group in the community—the investors—to the Government.

One difficulty, of course, in achieving a broad distribution of government issues lies in the current low rates of interest. During the World War the Liberty bonds which were sold to millions of investors throughout the country carried rates of 3½ to 4¼ per cent, which contrasts with the rate of ¾ of one per cent for recent issues of 5-year defense notes, and of but 2 per cent on recent Treasury issues of longer maturity. Naturally, rates so low are not conducive to large popular subscriptions.

Nevertheless, despite this handicap, much might be done to attract funds from genuine savers. It is probably not generally realized how large a portion of the increase in federal

debt during the past few years has been financed by sales to private investors, savings banks and insurance companies, and direct issues to the social security and other government trust funds. Out of the total increase in direct and guaranteed debt of $10 billions in the four years ended June 30, 1940, over 80 per cent was financed in this way. And this without any patriotic appeal or special effort to tap many of the important reservoirs of savings. Moreover, as employment and national income rises, the supply of savings will also increase. For these reasons, it is particularly encouraging to find the Treasury making plans to achieve the broadest possible distribution of defense issues.

Any increase in interest rates from the present artificially low level would be tremendously helpful, of course, in placing defense securities with the public. While higher interest rates may be opposed as increasing the cost of financing, such objections may well prove to be short-sighted. For if the insistence upon low rates leads to the loading of securities on to the banks, with a consequent expansion of credit, what is "saved" on debt service may be offset by an increase of prices of everything the Government has to buy.

Summary

To summarize then the three principal ways of financing the defense program: there is, first, economy, and we have much further to go in that direction; second, there is taxation, and we must prepare for heavier burdens, though with careful study as to timing and kinds of additional taxes; and, third, there is borrowing, which as the program develops should lean more and more upon genuine savings. If we vigorously attack the problem on all three fronts — economy, taxation, and borrowing from savings — we can hope to keep the inevitable expansion of credit within manageable proportions. But always we must bear in mind the basic principle, that if the volume of money — including bank deposits — is increased faster than the volume of goods and services to be paid for, we are sowing the seeds of inflation.

Unless we can keep the monetary situation under control we are practically certain to find that in the long run neither threats nor arbitrary "price-fixing" by government boards will enable us to ward off the usual consequences.

Great Britain's Dollar Resources

The statement of Great Britain's requirements for American dollars in 1941 and the resources available to meet them, which was presented by Secretary Morgenthau at a hearing on the Lease-Lend bill on January 15, and subsequently amplified, supplies the first official information on a question by which American public policy is greatly affected. A disclosure as complete and as candid as this is something new in international affairs, but there has never been a comparable situation. The British people want aid in obtaining war materials from this country; public opinion here has shown itself increasingly in favor of granting aid; and both the British and American authorities have wisely taken the view that the American people, whose representatives must determine the time and form of that aid, are entitled to know the British position.

Estimates of the gold and dollar resources available to the British when the war broke out were not difficult, and several good studies have been published, notably by the U. S. Department of Commerce and the Federal Reserve Board. Attempts to estimate the extent to which these resources were being reduced as the war went on, however, were hampered by the lack of such pertinent information as (1) the gold or dollars required to make payments to other countries outside the sterling area; (2) the extent of the drain due to withdrawal of funds from London during the early months of the war; (3) sums spent in expanding or building new plants in this country; (4) down-payments made on future deliveries of war materials; (5) effects of the war on interest and dividend payments, shipping and insurance earnings and similar items. Our own attempt to compile facts as to British gold and dollar resources after one year of war, published in the October issue of this Letter, was limited by this lack of information.

Thus this country has been largely in the dark as to the exact situation. It was realized after the French defeat, when the British took over the French contracts for munitions, that the drain on Britain's means of payment abroad would increase rapidly. Lord Lothian's appeal for assistance last November prepared American sentiment for a disclosure that financial underwriting of future British contracts would soon be required if the flow of war materials were not to be interrupted. Nevertheless, the figures given in the Morgenthau testimony came as a shock to many people.

Dollar Needs for 1941

Most of Mr. Morgenthau's figures are from British official calculations. The estimates for 1941 are reproduced below in condensed and rearranged form. The first item shows that the sum due in 1941 on orders placed here by the British Purchasing Commission is $1,274,000,000. Dollar needs for imports other than those purchased through the Commission are put at $280,000,000. The Dominions (other than Canada) and Crown Colonies are expected to spend here about $333,000,000, which roughly corresponds to the rate of their purchases in the last six months. In total, the Empire (out-

side of Canada) will need $1,892,000,000 in dollar exchange for payments due here. This covers only existing commitments, without allowance for the new orders the British want to place.

The British dollar requirements for payments outside the United States are large. First, it is estimated that net payments due to Canada in 1941, will reach $880,000,000, against which Canada is expected to supply "assistance," in the form of repurchases of Canadian securities held in Britain or accumulation of sterling balances in London, of $260,000,000. The remainder of $620,000,000 is listed as a "dollar deficit," which Britain expects to pay in gold or American dollars. Doubtless Canada requires gold or dollars rather than sterling, since she in turn has payments to make to the United States. Whether she expects these payments to be as high as $620,000,000 net, after utilizing her own resources, is not explicitly stated, and since the figure is higher than most current estimates the subject might well be elaborated.

A further $247,000,000 will be required by Great Britain for payments to other countries, for such things as Venezuelan oil, Dutch tin and rubber, neutral freights, etc.

Gold and Dollar Transactions of British Empire (excluding Canada) During 1941

(In Millions of Dollars)

British Dollar Requirements	United Kingdom	Other Empire	Total
Balance to be paid on war orders	1,274	—	1,274
Merchandise purchases from U. S.	280	333	613
*Service transactions with U. S.	—	—	5
Payments of U. S. dollars to Canada	—	—	880
Payments of U.S. dollars to other countries	—	—	247
Total	—	—	3,019
Methods of Settlement			
Newly mined gold (Australia & So. Africa)	—	555	555
Proceeds of exports to U. S.	165	560	725
*Service transactions with U. S.	—	—	15
Assistance from Canada	—	—	260
Total	—	—	1,555
Deficit to be met	—	—	1,464

*Including interest and dividends as well as shipping, insurance, etc.

The Empire's dollar requirements should not be considered, of course, a measure of our 1941 exports to the Empire, since many things ordered for 1941 have already been partly paid for. The British Empire absorbed in the last six months about two-thirds of our exports, representing an annual rate of about $2,400,000,000, of which Canada accounted for about $800,000,000. A study by the Federal Reserve Board recently expressed the opinion that our exports to the Empire in 1941 may reach $3,500,000,000.

Against the dollar needs of $2,759,000,000 (including $620,000,000 net for Canada), the Treasury puts receipts of dollar exchange from new gold, merchandise exports and services at $1,295,000,000, a deficit of $1,464,000,000. Just as dollar requirements are understated by not making allowance for new orders, so dollar receipts apparently have been conservatively estimated. The Empire may have more gold to sell than is allowed for, and possibly some of the dollars earned by the Dutch East Indies by sales of rubber and tin to the United States may be available to the United Kingdom in exchange for sterling. This, however, is necessarily a matter for negotiation.

The "services" rendered the U. S., and the earnings on British investments here, which as late as 1937 amounted together to about $150,000,000 net were put down at only $10,000,000. In explanation, Mr. Harry D. White of the Treasury staff pointed out that the British expected a shrinkage in interest payments on their investments in this country, that their earnings from shipping had greatly declined, and that large insurance payments had to be made on maritime losses. Naturally, no tourist trade can be expected.

The Drain on British Gold and Liquid Assets

The most striking revelation in Mr. Morgenthau's testimony was the extent by which British gold and dollar resources have declined. As will be seen from the accompanying table, these resources at the outbreak of the war were $4,483,000,000. Of this amount all but $2,167,000,000 had been used up by January 1, 1941. Furthermore, liquid assets immediately available for the payment of the deficit of some $1,464,000,000 in 1941 dollar accounts had shrunk to only $911,000,000. These liquid assets consisted of $616,000,000 of securities, $54,000,000 of dollar balances and $262,000,000 of gold, less a debit of $21,000,000 representing commitments on account of foreign exchange contracts. Private dollar balances, totaling $305,000,000, are excluded from this total, since the British consider it necessary to maintain these balances to carry on business.

Gold and Dollar Resources of the United Kingdom

(Approx. Figures in Millions of Dollars)

	Aug., 1939	Dec., 1940
Gold reserves	$2,038	$ 292*
Official dollar balances	50	54
Private dollar balances	545	305
Marketable securities (liquidat. val.)	950	616
Direct and miscel. investments	900	900
Total	$4,483	$2,167**

*Of this amount $30,000,000 of gold scattered in areas from which it cannot be shipped quickly or safely.
**The British had commitments of $21,000,000 on account of forward exchange contracts, which is a debit against this total.

The difference between the two totals tabulated signifies a decline of $2,316,000,000 in gold and dollar assets in the first sixteen months of the war. The decline in gold reserves

alone was no less than $1,746,000,000, over and above $965,000,000 of new and dehoarded gold shipped. Out of $2,038,000,000 held in the Equalization Account at the outbreak of hostilities, only $292,000,000 remain. The statement reveals, however, that the Empire has paid $225,000,000 of gold to Canada. How much of this remains in Canadian reserves is not told. It is known also that the gold holdings of the Reserve Bank of South Africa have risen over $100,000,000 since the outbreak of the war.

Mr. White, explaining the shrinkage before the House Foreign Affairs Committee, stated that the British Government, in addition to raising dollars for the payment of imports, had

"to meet dollar payments for plant expansion and advance payments which were very substantial. It had to meet dollars here for the withdrawal of sterling balances by Americans which it had permitted right along. It had to meet the dollars for some amount of illegal evasion of withdrawal of funds, and for withdrawals by other foreigners which the British permitted during the early months of the war when they weren't certain as to what the course of events would be. It had to meet dollars in order to pay for goods that they buy all over the world".

When the British took over the French purchase contracts in the United States, they got none of the French assets. As a result the drain on British resources was perhaps twice as great in the second half of 1940 as in the first half.

Payments made in these sixteen months are shown in the following condensed table:

Gold and Dollar Transactions of British Empire (excluding Canada) from Sept. 1939 to Dec. 1940

(In Millions of Dollars)

British Dollar Requirements	United Kingdom	Other Empire	Total
For war orders placed in U. S.			
Goods delivered	660	—	660
Advance payments on orders	570	—	570
Capital assist. for new plant	150	—	150
Total	1,880	—	1,880
Merchandise purchases from U. S.	705	435	1,140
Service transactions with U. S.*	197	48	245
Net payments to Canada (gold)	—	—	225
Payments to other countries	550	—	550
Withdrawal of capital**	735	—	735
Miscellaneous payments and items	71	—	71
Grand Total	—	—	4,346
Methods of Settlement			
Proceeds of exports to U. S.	205	640	845
Service transactions with U. S.*	140	30	170
Miscellaneous dollar receipts	—	50	50
Total	—	—	1,065
Gold:			
Newly mined and "dehoarded" gold	—	—	965
Gold from accumulated reserves	—	—	1,746
Total	—	—	2,711(a)
Capital movements			
Reduction of bank balances in U. S.	—	—	236
Liquidation of American securities	—	—	334
Total	—	—	570
Grand Total	—	—	4,346

Transactions of British Empire with Canada

Requirements			
Merchandise purchases	795	125	920
Service transactions*	—	10	10
Total	—	—	930
Methods of Settlement			
Proceeds of exports	170	100	270
Service transactions*	105	—	105
Gold	—	—	225
Capital movements (assistance)***	—	—	330
Total	—	—	930

(a) $225,000,000 of this amount was paid to Canada. * Including interest and dividends as well as shipping, insurance, etc. **Sales of free sterling, repayments of outstanding export credits as required by American Neutrality Act, and liquidation of forward exchange position in dollars. ***Repatriation of British-held Canadian securities and increase in sterling balances held by Canada.

Other Empire Assets

The gold and dollar assets of the British Dominions at the outbreak of the war have been estimated by the Federal Reserve Board as follows (in millions of dollars):

	Canada	Other Empire
Gold reserves	215	520
Dollar bank balances	355	100
Marketable securities (mar. val.)	445	50
Direct investments (book value)	475	5
Miscel. investments (var. val.)	80	10
Total	1,570	685

No statement is made as to the extent of these resources at present, or how far they may become available to the United Kingdom. The Dominions' resources of course are out of the United Kingdom's jurisdiction. The United Kingdom can acquire them only by buying or borrowing and can use them in this country only as they can be turned into dollars. The gold of South Africa, for example, is of no value for British purchases in the United States until after the British have bought it from South Africa, transported it to this country, and sold it for dollars. The same applies to every other Dominion resource.

Since the war started the Empire countries have accumulated large sterling balances in London. In this way they are assisting the British Treasury in meeting the cost of the war; but these balances are naturally of no use for the purchase of goods in the United States.

Liquidation of British Investments

The security markets are naturally concerned with the information as to British liquidation of American securities. The figure given for total sales, $334,000,000, is considerably larger than indicated by the regular Treasury reports on capital movements, which do not cover private sales. As announced by T. J. C. Gifford, special agent in charge of the sale of the British owned securities, 68 prominent issues (out of the 242 mobilized by the British Treasury since February, 1940) had been entirely sold by January 1, most of them through private negotiation. Including a large block of securities "called up" early in January, approximately 177 issues were still subject to liquidation. Security sales were accelerated in January, when blocks of stock in such companies as Montgomery Ward, F. W. Woolworth Co. and the Union Pacific Railroad were successfully sold "over

the counter". These sales have been carried out without seriously depressing effects on the markets.

The problem of the disposal of unlisted issues and of British direct investments in this country has been given a great deal of attention. Offers by groups of American investment trusts are said to have been transmitted to the British representatives in Washington; whether they will lead to sales remains to be seen. Many people in this country are unfamiliar with the nature of the British direct investments. They include, among others, wholly or partly owned American subsidiaries of many large and well-known industrial corporations; British individual interests; and also certain companies in which the British interest is more remote or indirect. The latter include Lever Bros., Thomas J. Lipton, Inc., and Shell Union Oil Corp., which are controlled by Dutch corporations. The following is a partial list of American corporations in which British interests are reported to be large or controlling:

British Company	Subsidiary
British American Tob. Co., Ltd.	Brown & Williamson Tob. Corp.
Baird Television, Ltd.	Baird Television Corp. of N. Y.
Bovril, Ltd.	Bovril of America, Inc.
J. & P. Coats, Ltd.	Clark Thread Co.
Courtalds, Ltd.	American Viscose Corp.
Crosse & Blackwell, Ltd.	Crosse & Blackwell Co.
Cunard Steam Ship Co., Ltd.	Cunard White Star, Ltd. (Eng.)
Decca Record Co., Ltd.	Decca Records, Inc.
Distillers Company, Ltd.	Distillers Co. Ltd. of Del.
Alfred Dunhill, Ltd.	Alfred Dunhill of London, Inc.
Dunlop Rubber Co., Ltd.	Dunlop Tire & Rubber Corp.
English Sewing Cotton Co., Ltd.	American Thread Co.
Furness, Withy & Co., Ltd.	Various

British insurance companies have been active in this country for many years. A recent tabulation by Alfred M. Best Company, publishers of insurance manuals, showed 43 U. S. branches of British fire companies and 32 British controlled domestic fire companies, of which the total capital and surplus (not including the companies' equity in unearned premiums) on December 31, 1939 was $236,000,000. On the same date, there were seven U. S. branches of British casualty insurance companies and nine British controlled domestic casualty companies, with capital and surplus of $98,000,000.

How much could be realized by the British on their investments is at present impossible to determine. It is entirely a question of marketability. As the January Federal Reserve Bulletin points out, there is no one figure that really measures British dollar resources. The Bulletin says:

> Even the best securities may shrink in value if pressed in too great volume upon the market. Others may have no ready market at all. So-called direct investments—i.e., investments representing controlling interests—may be almost impossible to convert into cash; or again, if entire companies can be sold as going concerns, they may offer the best means of raising a large lump sum within a short period. . . . Moreover, any figure that can be given for securities or investments must be regarded more as indicative of possibilities that may be realized under certain facilitating circumstances than as a definitive measure of dollar resources that can be promptly turned to war purchases.

Appearing before the Senate Foreign Relations Committee on January 28, Mr. Morgenthau is reported as saying that the British are arranging to sell "within twelve months" the property they own in the United States.

British Investments Outside the U. S.

To complete the picture of the financial position of Great Britain, Mr. Morgenthau also presented data from British sources on British long-term investments outside the United States. Of course they cannot be used to relieve the present emergency unless they can be converted into dollars; and it is unlikely that more than a small portion of these huge investments, whose nominal value at the outbreak of war was put at £3,868,000,000 or about $15,500,000,000 at the present rate of exchange, would find a ready market in this country. A considerable share of the total is located in the war areas or is in the form of sterling government securities of various Empire countries. The nominal value of British investments in Canada and Latin America (other than government paper) is about £1,170,000,000.

A shift in the ownership of these securities from one country to another would have far reaching effects, which should have consideration. Problems of international payments and transfer difficulties in many areas would be immensely aggravated. Great Britain has normally an import balance with Latin American countries. Thus by her own purchases she provides them with sterling exchange for the payment of debt service. If this country owned the Latin-American investments, it could collect the interest, dividends and payments only by increasing its purchases from Latin America commensurately above the present level. But already the principal problem in our Latin American relations is to increase purchases of their products. The fact that South American products are to an important extent the same as our own makes acute difficulties. At the same time, were Great Britain's position as a creditor nation greatly modified, her purchases from Latin America would have to be curtailed for lack of necessary exchange.

How Many Branches Should a Bank Have?

ABRAHAM LINCOLN answered a question like that once. "How long should a man's legs be?" they asked him. And the slow drawl came back, "Long enough to reach the ground." Same way with a bank. You need enough branches to reach your customers and to serve them well. Because conditions change, banks change, adapting themselves to their customers' needs. Sometimes this means lopping off a branch that has outgrown its usefulness; often it means adding a new branch where it is most needed.

National City is adding a new branch this month. As with all the other service units we have opened since our first branch banking experiment in New York City, back in 1921, we hope this new one will enable us to serve our customers better. **195 Broadway Branch** will bring the present number of National City branches in Greater New York to 70.

It's just twenty years since National City made banking history by ceasing to be a "one-address" bank in New York, and opening a 42nd Street branch for the greater convenience of its customers. Today, in one way or another, almost one out of every eight people in New York transacts business with or through National City. We try to serve them well. And we hope they feel that our legs are truly long enough to reach the ground—our customers' best interests.

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